DEPARTMENT OF PUBLIC SERVICE REGULATION
BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MONTANA

IN THE MATTER OF the Joint Application of NorthWestern Corporation and Babcock & Brown Infrastructure Limited, BBI US Holdings Pty Ltd., BBI US Holdings II Corp., and BBI Glacier Corp. for Approval of the Sale and Transfer of NorthWestern Corporation Pursuant to a Merger Agreement	)))))))	UTILITY DIVISION DOCKET NO. D2006.6.82

Rebuttal Testimony of

Jonathon Sellar
Chief Financial Officer
Babcock & Brown Infrastructure Limited

Protected Version

January 22, 2007

Q. Please state your name and describe your position.

A. My name is Jonathon Sellar. I am the Chief Financial Officer of Babcock & Brown Infrastructure Limited ("BBIL") and the BBI Companies

Q. Please summarize your experience.

A. I have been the Chief Financial Officer of BBIL since September 1, 2005. Prior to that appointment I was Group Financial Controller of BBI since November 2002. BBI was listed on the Australian Stock Exchange in June 2002 so I have essentially been with BBI since the early days of the company.

My most recent role prior to joining BBI was as the Project Controller of InterGen's Australian power stations. Prior to this role at InterGen, I was a Senior Audit Manager (Energy & Mining) at PricewaterhouseCoopers Brisbane, Australia, which included two and a half years in the United Kingdom.

I hold a Bachelor of Business (Accountancy) from the Queensland University of Technology (Brisbane, Australia), and have been a member of the Institute of Chartered Accountants in Australia since 1996.

Q. What is the purpose of your testimony?

A. My testimony addresses our concerns with the analysis performed by Dr. Wilson as reflected in his testimony, particularly where it references aspects of the BBI acquisition model.

Q. Is Dr. Wilson's analysis of BBI's financial projections accurate?

A. No. As Steve Boulton indicated in his testimony, we believe Dr. Wilson's testimony contains certain material flaws in its underlying analysis of the impact of the transaction on NorthWestern's customers. Those flaws are largely the result of his misapplication of the acquisition model used by BBI in evaluating an acquisition of NorthWestern, but also appear to result from an attempt to selectively use data to justify erroneous conclusions. The analysis inappropriately applies BBI's acquisition model to a public utility ratemaking process, and goes so far as to claim it shows how NorthWestern will operate after its acquisition by BBI.

Q. Please provide an overview of the errors in Dr. Wilson's analysis.

A. Although there are several aspects of the analysis which merit special address, it is probably best to take as the starting point the improper application of the acquisition model to public utility ratemaking. The model was not designed to be used to establish utility rates, and was not intended, or is even capable of, modeling the actual operations of NorthWestern after its acquisition by BBI. The acquisition model was used by BBI to evaluate the acquisition of NorthWestern and was intended solely to guide the management of BBI in making an investment decision at the time such decision was made in early 2006. For example, the BBI acquisition model includes the entire investment consideration to be paid by BBI to acquire NorthWestern (including the premium to book). This does not mean, in any way, that BBI and NorthWestern expect to recover the premium to book in rates, as Dr. Wilson suggests in his testimony. On the contrary, BBI has repeatedly and clearly stated in this docket, as well as others, that it does not expect to recover the premium to book in rates. Given that the purpose of the model was to evaluate BBI's entire economic investment in NorthWestern, it would have been fundamentally wrong for BBI not to include the premium to book in its acquisition model.

Q. Why would it have been fundamentally wrong for BBI not to include the premium to book in its acquisition model, given the model's purpose?

A. Although BBI and Northwestern have clearly indicated that the premium to book will not be included in NorthWestern's rates for regulated utility service (nor could it be without the express authorization of the Commission) the premium to book will in fact be paid in cash by BBI. Since the purpose of the model is to evaluate the impact of the transaction on the BBI stockholder, the premium to book has to be reflected in the acquisition model for the model to accurately reflect BBI's entire economic investment. BBI would be irresponsible not to take all of its acquisition costs into account in evaluating the acquisition of NorthWestern.

Q. Does NorthWestern's capitalization for regulatory purposes change as a result of this transaction?

A. No. NorthWestern's capitalization for regulatory purposes does not change as a result of this transaction.

Q. Please identify the aspects of Dr. Wilson's analysis, which merit special address.

A. At page 4 of his testimony, Dr. Wilson claims that BBI plans to support its financing of the acquisition by substantially increasing NorthWestern's payouts to equity owners. The analysis states that BBI is distributing materially more cash ($660 million) during the period 2007 to 2010 than the amount projected by NorthWestern in its 2006 Long Range Forecast ($203 million). A correct analysis would conclude that the net distributions assumed by BBI and NorthWestern during this period are approximately equal. Whereas the model shows distributions of $660 million to BBI, it also shows a significant reinvestment of equity capital by BBI during this same period ($405 million), thereby resulting in a net distribution over the referenced time frame of $255 million. The NorthWestern Long Range Distribution forecast during the same period ($203 million) is only slightly lower.

At page 5 of his testimony, Dr. Wilson identifies four major concerns with BBI's acquisition of NorthWestern, and each of his stated concerns is again linked to his misuse of the BBI model. Specifically, his analysis of the model seeks to establish that the following will occur after BBI acquires NorthWestern:

1. NorthWestern intends to retain for ratemaking the premium to book offered by BBI;
2. NorthWestern intends to invest, on an annual basis, less than its annual depreciation expense;
3. BBI projects a 25 to 30% return on its investment in NorthWestern by 2023; and

4. BBI proposes to recover "phantom taxes" from the NorthWestern ratepayer.

I have already explained why the first concern, retention of the premium to book, is misplaced. For ratemaking purposes, the Montana regulated rate base, and the debt and equity components thereof, are effectively determined by the Commission, not by BBI or NorthWestern. To the extent that the regulated rate base is known and determinable, and the amount and percentage of debt in rate base is subject to Commission oversight and approval, then the amount of equity in rate base also is known and determinable.

Currently, NorthWestern maintains an approximate 50/50 debt to equity ratio in respect of its regulated rate base. While the equity component will only increase as the total rate base increases (i.e., without increases in the amount of permitted debt, all regulated utility-related capital expenditures are funded out of equity only) the debt component can only increase if the Commission allows NorthWestern to raise additional rate-based debt in order for NorthWestern to maintain an acceptable leverage ratio. Thus, for Montana ratemaking purposes, the equity percentage in rate base will likely increase over time, not decrease.

Q. Upon what basis did you say that each of his four major concerns is linked to his misuse of the model?

A. Dr. Wilson relies exclusively on his assessment of the model to justify his claims regarding equity distributions, capital expenditures, borrowing and earnings. At no time does Dr. Wilson reference any of the other wide-ranging and detailed data and information provided by BBIL and NorthWestern. The BBIL acquisition model simply was not designed to be employed for the purpose for which it has been used by Dr. Wilson.

The acquisition model was developed as one of several acquisition tools for BBIL to utilize in valuing NorthWestern as an entity for purposes of developing the BBIL bid, and was not developed to be used to project expected accounting GAAP earnings, evaluate individual components of the Company, specify its capitalization, ascribe financings to specific projects (whether recourse or non-recourse), identify specific rate case parameters or specific cash flow and tax projections or to construct accounts for rate filings on regulated assets covered by local jurisdictions.

Given the intended uses of the acquisition model in valuing NorthWestern, BBIL did not focus on GAAP reported earnings and made conservative and simplifying assumptions in respect of reported income tax expense and GAAP depreciation charges where actual information was not available in the NorthWestern data room. In particular, for GAAP purposes it was assumed, conservatively, that the existing NorthWestern asset base would be depreciable on a straight-line basis over 17 years from acquisition. That assumption has proven to be overly conservative, as the actual expected remaining depreciable life of the assets acquired at the date of acquisition is likely to be substantially longer than the 17 years used in the acquisition model. Likewise, BBIL conservatively assumed that the existing assets would be depreciated for tax purposes on the same straight-line basis over the same 17-year term. Realistically, the tax depreciation will be more accelerated in the early years and slower in the later years.

The acquisition model does not distinguish between recourse and non-recourse debt financing. Nor does it specifically ascribe financings to individual projects, other than for certain major projects. Consequently, while it was always intended that the MT-ID Pathway transmission project must necessarily be financed on a non-recourse basis to NorthWestern (as it is not a conventional Montana utility rate-based asset), the model does not make such a distinction. Nor does it ascribe the specific assets to which the two proforma $90 million debt-refinancing proceeds at NorthWestern level are attributable. In fact, the model aggregates all debt financing together in determining a consolidated debt/equity ratio for NorthWestern for modeling purposes only. This simply allows BBI to maintain a consistent proforma consolidated capitalization ratio in the model.

As noted in Steve Boulton's response to Dr. Wilson's Fourth Recommendation, the Commission regulates the issuance of debt securities, including pledges of utility property (liens), under Montana law. Consequently, any BBI financing for assets that are not included or includable in NorthWestern's utility rate base, or that are devoted to any purpose other than providing funds to NorthWestern for its public utility operations, will be non-recourse to NorthWestern. This basic protection to Montana ratepayers does not change and BBI has confirmed its commitment to ensure that any new debt associated with non-utility assets will be appropriately ring fenced from the regulated assets of NorthWestern.

Q Please address Dr. Wilson's second stated concern on page 5 of his testimony that the model shows that NorthWestern, post acquisition by BBI, intends to re-invest less than its annual depreciation rate.

A. First, I believe that comparing capital expenditure to a GAAP depreciation charge is not appropriate. Capital expenditure forecasts are dynamic, based on expected capital requirements of the network on a prospective basis taking into account projected increases in population, usage, retirements and replacements and other growth characteristics. GAAP depreciation, on the other hand is a more static analysis, reflective only of historic costs. In fact, the capital expenditure profile included in the BBI acquisition model was based on estimates provided by NorthWestern management during the due diligence process and was confirmed by an independent engineer retained by BBI to provide an opinion of the appropriateness of NorthWestern's capital program. The Independent Technical Review prepared by Stone & Webster Management Consultants, BBI's independent engineer, was provided during the discovery process in response to MPSC Data Request No 1, Question PSC-017(d). The key findings of this report were that: (i) NorthWestern's historical capital expenditures appear to be consistent with good utility practices, (ii) system performance is within reasonable levels and (iii) NorthWestern's forecast capital expenditure is consistent with Stone & Webster's expectations. Therefore, a comparison of forecast capital expenditure to a GAAP depreciation charge is neither relevant nor reasonable.

Second, the time period chosen (i.e., the first 15 years) in Dr. Wilson's analysis of capital expenditure as a percentage of GAAP depreciation is the period during which BBI's model assumed that the existing assets of NorthWestern would be almost fully depreciated for GAAP purposes (i.e. he apparently limited his analysis to the period during which reported GAAP depreciation is at its highest and yields the worst result for this analysis). We previously have noted that BBI conservatively estimated a 17-year remaining GAAP depreciable life for NorthWestern's existing asset base. Dr. Wilson was made aware of the nature of that estimate. If the same analysis performed by Dr. Wilson is extended over the entire life of the BBI model (i.e., 40 years) capital expenditures are well in excess (115%) of GAAP depreciation expense measured on a consistent basis to the analysis performed by Dr. Wilson.

The analysis performed by Dr. Wilson is also inconsistent in that it included in depreciation expense the cost associated with the assumed acquisition of the non-regulated Colstrip Unit 4 buyout ($153.8 million), but did not include that same capital cost in his calculation of capital expenditures over the period. This is an inconsistent and faulty approach. This single difference makes up a more than half of the purported "shortfall" over the referenced period. If we then adjust for the assumed 17-year remaining GAAP depreciable life of NorthWestern's existing asset base to better reflect expectations (we assumed 25 years), and include all depreciation and capital expenditures through the end of 2023, then, over this period, NorthWestern will make capital expenditures well in <u>excess</u> of book depreciation (by $258 million), as opposed to Dr. Wilson's claimed shortfall (of $300 million). Over thirty years, capital expenditures further exceed GAAP depreciation (by almost $360 million) and over the full forty-year evaluation period, the excess of capital expenditures over depreciation increases even more substantially (to nearly $800 million).

Q. Please address Dr. Wilson's third stated concern that the model shows that BBI will be earning a return on its investment in NorthWestern of 30% by 2023.

A. The total internal rate of return to BBI in respect of the overall consolidated NorthWestern transaction over the full forty-year evaluation term is 11.9%, well below the returns referenced by Dr. Wilson. This return is prominently displayed in the header of every page of the BBI acquisition model and easily ascertained by Dr. Wilson. Based on its acquisition model, that is the total return BBI projects to earn in respect of its ownership of NorthWestern over time, including in respect of its total business (regulated and unregulated). As one would expect, BBI's anticipated overall returns on NorthWestern's regulated businesses in Montana, South Dakota and Nebraska are less than its expected returns on the Company's unregulated businesses (otherwise it probably wouldn't invest in such unregulated businesses).

Dr. Wilson's testimony presents his analysis of the year-to-year return on the consolidated NorthWestern cash flows (including all regulated and unregulated businesses). However, this docket is primarily concerned with the regulated Montana business of NorthWestern, which he did not address.

A return on investment in respect of the regulated Montana gas and electric rate base yields a completely different and less startling conclusion. Over the 17 year evaluation period referenced by Dr. Wilson, the return on investment on the NorthWestern regulated Montana electric business is projected in the BBI acquisition model to be 7.5% and the return on the NorthWestern regulated Montana gas business is projected to be 7.7%. Moreover the model shows that the returns on both of these businesses are substantially lower over the next several years than over the longer term.

Dr. Wilson's analysis determines a rate of return on equity funded rate base ("RREFRB"). The methodology Dr. Wilson chose to calculate the metric incorporates the entire operating company's financial results, including unregulated and regulated businesses. In order to properly review the Montana regulated businesses' RREFRB each business unit's specific ratio should be presented, instead of the consolidated metric. For example, the RREFRB metric is not relevant for unregulated businesses and, therefore, distorts the conclusions reached by Dr. Wilson significantly with respect to the regulated Montana utilities.

Using consolidated numbers (i.e., regulated and unregulated) misrepresents the results for several reasons. First and foremost, each business unit will have distinct profit and investment profiles. One certainly would not expect an unregulated business to have the same level of profitability as a regulated business. Each of the regulated businesses also has different allowed rates of return as well as different actual/historical returns. Finally, while the net plant of utilities should grow slightly over time, unregulated businesses do not necessarily demonstrate that profile. In fact, a power plant after 30 years could have zero to minimal Net PPE and still have positive net income, which would result in an <u>infinitely</u> high RREFRB metric.

We used Dr. Wilson's exact methodology to calculate the RREFRB metric for each of the utilities as a standalone business from the BBI acquisition model. The RREFRB ratios for each of the Montana utilities are substantially lower than the consolidated numbers provided by Dr. Wilson. For the regulated Montana assets, the RRFERB through 2023 for the Montana electric assets is 7.5% and for the Montana gas assets it is 7.7%. I believe that these returns are low when measured against the current allowed capital structure and return on equity for the Montana regulated businesses. NorthWestern's and BBI's expectation is that NorthWestern would receive its Commission authorized return on equity from its regulated businesses.

Within the BBI acquisition model it is possible to examine metrics of individual business units (e.g., the Montana regulated gas business and the Montana regulated electric business) and therefore it was possible for Dr. Wilson to focus an analysis of return on investment to just the Montana regulated utility. He chose to not perform his analysis in this way.

Q. Please address Dr. Wilson's fourth stated concern that BBI intends to recover "phantom taxes" from the NorthWestern ratepayer.

A. The existence and availability of the net operating losses carry forward ("NOLs") to NorthWestern as a group (which includes both regulated and unregulated businesses, both within and outside of Montana) is irrelevant to a consideration of whether the acquisition of NorthWestern by BBI will adversely affect NorthWestern's continued ability to provide adequate service at just and reasonable rates. The NOLs that reside within NorthWestern were generated by the write-off of some of NorthWestern's now defunct unregulated businesses. The investments giving rise to the NOLs were never included in rate base. These NOLs (that reduce cash tax paid during this period) have no connection with NorthWestern's regulated Montana utility business. The effect of using these NOLs is that there is higher available cash flow during this period after payment of all operating expenses, cash taxes, debt service, capital expenditures and the retention of sufficient working capital and liquidity to fund the day-to-day operating requirements of the business.

Q. In his testimony, Dr. Wilson portrays what he contends is the NorthWestern capital structure under the BBI model. Has he correctly portrayed the capital structure of NorthWestern after its acquisition by BBI for purposes of determining ratepayer impact?

A. No, he has not. Beginning on Page 12 of his Testimony, Dr. Wilson attempts to draw the conclusion that as a consequence of two large capital projects in Montana planned by NorthWestern (the MT-ID Pathway and the Colstrip Expansion Project) and which BBIL would expect to undertake, NorthWestern debt will substantially increase from it current levels at the date of acquisition ($736 million) in 2006 to $1.854 billion by the end of 2009, while equity will decline from $732 million to $531 million. That simply is not true. The vastly larger of the two projects (MT-ID

Pathway) is not intended to be included in conventional utility rate base and therefore the financing of this project will be fully non-recourse to NorthWestern, as will the cost of the buyout of the Colstrip Unit 4 interest if that occurs. Moreover, the current $736 million of debt in NorthWestern's rate base calculation can not change unless authorized by the Commission.

Also, when the Commission establishes rates for one of its jurisdictional utilities, it typically applies what it considers to be an "efficient" utility capital structure. In other words, what Northwestern reflects in its capital structure in accordance with GAAP does not control what the Commission utilizes in rate making. What Dr. Wilson also fails to point out is that in the year immediately following his 2009 calculation, BBIL injects a significant amount of equity capital (in excess of $400 million) into these projects to repay short-term, non-recourse construction debt and achieve a 50/50 D/E capitalization for the largest of the projects as well as an approximately 50/50 D/E capitalization for NorthWestern on a consolidated basis.

Q. Dr. Wilson, using information from the BBI acquisition model, contends that BBIL contemplates equity distributions that are aggressive and unrealistic, particularly in comparison with a group of sample companies, which he developed. Is the comparison appropriate?

A. No, it is not. Dr. Wilson's exhibits compare the acquisition model's projected BBIL distributions over time to projected data for a poorly selected reference group of utilities to NorthWestern. In these exhibits, he attempts to conclude that BBIL's projections are unrealistic and excessive. If, however, several conforming adjustments are made to the BBIL projections, to make them actually comparable (e.g., removal of planned but not yet committed and non-recourse financed major capital projects), and to revise and expand the control group of utilities to focus on those companies that are similar to NorthWestern, (i.e., with primarily regulated assets), BBIL's projections are entirely consistent with historical distribution percentages of the control group (refer to Exhibit 1).

Dr. Wilson's uses Value Line projections to conclude that utilities typically would expect to make equity distributions of approximately 63% of net earnings. Historically, however, as shown in Exhibit 1, over the past ten years, similar utilities have made distributions that have averaged 91% of net earnings. In practice, one would expect the actual distribution of a publicly traded utility to exceed market advice or projections since there is little reason to "over project", and several reasons to under-project dividends, including avoiding shareholder actions. As a BBI subsidiary, however, there is no need to under-project NorthWestern's distributions. Using 91% as a base, we then address BBIL's projections. To be directly comparable, as discussed above, we should evaluate NorthWestern on a stand-alone, going-forward basis, excluding atypical aspects of the business. To reiterate, we have made the following modifications:

1. Corrected for tax and GAAP depreciation assumptions as noted above;
2. Treated NorthWestern as a full, standalone taxpayer in each year;
3. Eliminated the MT-ID Pathway and Colstrip expansion projects and associated financings; and
4. Retained the acquisition premium to book in relevant debt / equity and other calculations.

With the above modifications the BBIL distributions as a percentage of net earnings are entirely consistent with the historical distributions of the control group.

	Distributions as a % of net Earnings	
	Wilson Calculation	**BBIL Calculation**
2007	139%	90%
2008	282%	97%
2009	157%	92%
2010	180%	89%
2011	138%	92%
Control Group 10-Year Average 1996 - 2005	91%	

Information in respect of the Control Group is included in Exhibit 1.

Q. Please address Dr. Wilson's concern that BBI is not retaining enough cash in the business

A. Dr. Wilson's testimony notes that the projected BBI Holdco financial statements indicate an ongoing balance of less than three days of revenues. (Wilson Testimony at Page 14, Lines 6-8). Again, Dr. Wilson is using our acquisition model for purposes it was not designed, such as to model the working capital management of NorthWestern. It is my understanding that NorthWestern today maintains small cash balances and uses excess cash to minimize its outstanding borrowings under its revolving credit facility. Post-acquisition, we would expect that NorthWestern would manage its cash balances and utilize its revolving credit facility as it does today. This facility would continue to be a source of liquidity for NorthWestern and only excess cash not needed to manage its liquidity would be distributed up to BBI on a periodic basis (quarterly).

Q. Do you have any concluding remarks?

A. Yes. Contrary to the assertions of Dr. Wilson, it is not, nor has it ever been, the intention of BBI to extract excessive distributions from NorthWestern so as to render it incapable of providing adequate service at just and reasonable rates. BBI is a long-term utility investor, committed to ensuring that NorthWestern remain a capable, financially strong, customer focused utility that will serve customers well for decades to come.

Q. Does this complete your rebuttal testimony?

A. Yes.

Exhibit 1.

Comparable Companies with Mostly Regulated Business Activities

		Historical Dividend / Earnings Ratio (source: Bloomberg)										
Ticker	Company	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	Average
ALE	Allete Inc.	90%	84%	77%	109%	53%	59%	65%	39%	76%	276%	93%
AVA	Avista Corp.	93%	66%	83%	153%	31%	207%	81%	56%	71%	59%	90%
CGC	Cascade Natural Gas	218%	93%	110%	79%	69%	62%	99%	117%	81%	118%	105%
CHG	CH Energy Group	73%	73%	76%	77%	73%	71%	85%	77%	78%	75%	76%
CV	Central Vermont Public Services Group	60%	77%	301%	72%	66%	475%	62%	59%	51%	191%	142%
EDE	Empire District Electric Co.	104%	99%	85%	107%	95%	188%	109%	99%	149%	139%	117%
FPU	Florida Public Utilities Co.	64%	57%	61%	57%	61%	69%	65%	18%	66%	58%	58%
GAS	Nicor Inc.	48%	53%	60%	59%	212%	65%	63%	78%	109%	60%	81%
GMP	Green Mountain Power Corp.	96%	102%	-	-	-	35%	30%	36%	39%	47%	55%
GXP	Great Plains Energy Inc.	94%	136%	87%	130%	66%	-	85%	80%	67%	77%	91%
IDA	Idacorp Inc.	86%	81%	80%	78%	52%	56%	114%	139%	63%	80%	83%
ILA	Aquila Inc.	82%	77%	72%	69%	54%	48%	-	-	-	-	67%
MAM	Maine & Maritimes Corp.	141%	-	90%	32%	37%	39%	34%	104%	139%	-	77%
MGEE	MGE Energy Inc.	319%	92%	94%	89%	79%	82%	79%	79%	77%	87%	108%
NWN	Northwest Natural Gas Co.	63%	70%	118%	73%	67%	67%	79%	72%	69%	63%	74%
PNM	PNM Resources Inc.	21%	33%	40%	40%	32%	21%	53%	39%	44%	73%	40%
PSD	Puget Energy Inc.	98%	138%	99%	86%	74%	133%	83%	71%	158%	57%	100%
UIL	UIL Holdings Corp.	100%	89%	91%	80%	69%	68%	93%	177%	48%	134%	95%
VVC	Vectren Corp.	-	-	-	64%	85%	133%	63%	71%	81%	66%	80%
WGL	WGL Holdings Inc.	63%	78%	82%	69%	72%	155%	56%	65%	62%	75%	78%
WR	Westar Energy Inc.	87%	28%	302%	1015%	72%	-	-	68%	31%	55%	207%
											Average	91%

Note: Includes public electric and gas utility companies with market capitalization of less than $3.0 billion as of January 19, 2007. Companies whose regulated income is less than 75% of total income were omitted. "-" means that there were negative or zero net income in that year and was excluded from calculations. As a comparison, NorthWestern's 2005 income from regulated sources was 80%.

Dr. Wilson's sample consisted of 10 companies. Two (CHG & UIL) are included in our sample. Four (CNP, DQE, NU & SRE) were excluded from BBI's sample because their utility earnings for 2004 & 2005 averaged less than 75% of total earnings. Four (EAS, ED, NST & POM) were excluded from BBI's sample because their market capitalization exceeded $3.0 billion.

Source: Bloomberg, S.E.C. reported financial statements and annual reports